**Introduction**

The European Commission’s proposal for a Directive and Regulation (collectively known as CRD IV) will replace the existing Capital Requirements Directive and implement the Basel III accord in Europe. Basel III made a number of significant changes to the Counterparty Credit Risk (CCR) capital regime, including the introduction of Credit Valuation Adjustment (CVA) as an additional capital requirement to CCR related risk exposures. Changes are also made to the capitalisation of CCR under the internal model method and are proposed on the capitalisation of exposures to central counterparties (CCPs).

For more detail on Counterparty Credit Risk under Basel III please see the AFME Briefing Note on [Counterparty Credit Risk](#).

**CRD IV Overview**

In the context of Counterparty Credit Risk, CRD IV follows the same principles as Basel. Institutions are required to capitalise on Credit Valuation Adjustment, in order to capture the potential mark-to-market associated with the deterioration in the creditworthiness of a counterparty, in relation to over-the-counter (OTC) derivatives. Further changes include stressed effective expected positive exposures.

CRD IV has incorporated Basel’s proposal on the capitalisation of CCP exposures, where such a capital charge requirement is dependent on a CCP’s hypothetical capital.

**AFME’s Positions**

*Calibration of Credit Valuation Adjustment*

Discussions on the treatment of CVA are being held as part of the wider trading book review being undertaken through the Basel Committee on Banking Supervision’s (BCBS) working groups. In particular, there are a number of methodological and material technical issues that have not yet been resolved. The BCBS Fundamental Review of the Trading Book is best attuned to resolve these issues taking into account the unintended consequences. Therefore, future amendments are expected from the Basel Committee. The CRD IV CVA section is based on the Basel III text and thus, more time should be allowed for further study of the calibration of the CVA charge, both on standardised and advanced approaches, to take into account specificities of European business models and accounting frameworks, and the diversity of the client base. CRD IV could introduce an observation and reporting period until 2015. This would allow a review in 2014 to take into account the work being undertaken by the Basel Committee, and to ensure that the accounting treatment is consistent with international accounting standards. In any event, the EU should not follow the suggested Basel timetable unless the
US does the same and only after reviewing the relative impact on the EU economy. It is important also to appreciate the procyclicality embedded in the CVA calculation methodologies. If this cannot be eliminated, it should be taken into consideration in the management and calibration of the countercyclical buffer.

**CVA Charge for certain non-financial corporate counterparties**

The requirements for OTC derivatives have been developed under the European Market Infrastructure Regulation (EMIR) as part of the G20 primary objective of mitigating systemic risk. Certain non-financial corporate counterparties, which are not systemically important, have been exempted from clearing obligations under EMIR. Clearing exemptions granted to such counterparties should not be undermined with higher and disproportionate capital charges under CRD IV. We support alignment between CRD IV and EMIR objectives towards such counterparties.

**Credit Valuation Adjustment Hedging**

Large CVAs arise in derivative portfolios where counterparties do not post collateral. This imposes large CVA charges on institutions for which the counterparty is a sovereign, because it is common practice for sovereigns not to post collateral at the time of the transaction. Under the current proposals, the only way to reduce this CVA charge is to purchase single name Credit Default Swaps (CDSs). In addition, limited CDSs are available in the market to hedge CVA charges on transactions with SMEs and medium-sized corporates.

**Capitalisation of exposures to central counterparties (CCPs)**

The CRD IV text includes the new capital requirement on exposure to CCPs, which is yet to be finalised. Different levels of capital charges will be determined depending on whether the amount of default funds is larger or smaller than the CCP “hypothetical capital”. CCPs are only allowed to use the current exposure method to calculate hypothetical capital. A number of issues have arisen related to this proposal, with implications that this new capital requirement will discourage the propagation of central clearing, in contrast to the policy objective stated by the G20. It could also potentially result in a misallocation of capital and liquidity on a macroeconomic scale with strong pro-cyclical effects when market conditions become distressed. The Basel Committee’s Risk Management and Modelling Group (RMMG) is reviewing the technical standards. A revised proposal is currently at its consultation stage, and some of the changes made in this proposal are not yet reflected in the CRD IV text. In addition, the final Basel text is yet to be published and it is likely to be changed. Thus, consideration could be given to allow the CRD IV text to be adapted through the legislative process to deal with developments that occur at the Basel level and should allow these provisions to be adjusted at a later point, e.g. to deal with unintended consequences.

**System and Technical Implementation**

In addition to the above point, consideration could be given to the implementation of the CCR framework. The calculations for CCR and CVA rely heavily on the bank's IT system infrastructure. With the tight timelines and unsettled issues still remaining at the Basel III level, institutions will have limited time to update their infrastructure and, more importantly, to perform sufficient use tests before the models can be used. Both systematic and operational risk may rise significantly. Moreover, some of the timeframes foresee the EBA producing standards (for example on model quality) which are due only by the start of the implementation period, yet banks and their regulators will need these to be in place well before (6 - 12 months) in order to ensure compliance.

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* CRD IV and Basel III issue
+ Issue specific to CRD IV
Further information

AFME has broken down positions on the key CRD IV issues in more specific briefing notes:

- Overview of CRD IV
- Capital and Capital Buffers
- Leverage
- Liquidity

See also AFME's material covering Basel III:

- Overview of Capital Requirements Reform

All of these documents are available on the AFME website.

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